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Supreme Court of the United States

OCTOBER TERM, 1957

No. 1019

JAMES R. WATKINS and LUCILE L. WATKINS,

Petitioners,

—v.—

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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UNITED STATES OF AMERICA,

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable Chief Justice of the United States and Associate Justices of the Supreme Court of the United States:

Your petitioners, James R. Watkins and Lucile L. Watkins, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered on February 26, 1958 in the above entitled action.

Opinions Below

The Opinion of the Court of Appeals is reported in 252 F. 2d 722 *infra* Appendix A and the Opinion* of the United States District Court for the District of Connecticut is reported in 149 F. Supp. 718.

* Since nine additional copies of the record as printed for use in the Court of Appeals have been filed pursuant to Rule 21(4), neither Exhibit A nor the opinion of the District Court is appended to this petition.

Jurisdiction

The date of the judgment to be reviewed is February 26, 1958 *infra* Appendix B. Jurisdiction of the Court is invoked under Section 1254 of Title 28 of the United States Code (Act of June 25, 1948, c. 646, 62 Stat. 928).

The jurisdiction of the District Court was invoked under Section 1346 of Title 28 of the United States Code, as amended.

Statutes Involved

The statute involved with respect to the years 1949 and 1950 is Section 117 (a)(4) of the Internal Revenue Code of 1939 which provides:

> "Sec. 117. (a) Definitions.—As used in this chapter—
>
> * * * * *
>
> (4) Long-Term Capital Gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;"

The statute involved with respect to the years 1951 and 1952 is Section 117 (q) of the Internal Revenue Code of 1939, as added by Section 1 of the Act of June 29, 1956, c. 464, 70 Stat. 404, which provides:

> "(q) Transfer of Patent Rights.—
>
> (1) General Rule.—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange

of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(A) payable periodically over a period generally coterminus with the transferee's use of the patent, or

(B) contingent on the productivity, use, or disposition of the property transferred.

(2) 'Holder' Defined.—For purposes of this subsection, the term 'holder' means—

(A) any individual whose efforts created such property, or

(B) any other individual who has acquired his interest in such property in exchange for consideration in money or money's worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither—

(i) the employer of such creator, nor

(ii) related to such creator (within the meaning of paragraph (3)).

(3) Exceptions.—This subsection shall not apply to any transfer described in paragraph (1)—

(A) by a nonresident alien individual, or

(B) between an individual and any related person. For purposes of this paragraph, the term 'related person' means a person, other than a brother or sister (whether of the whole or half blood), with respect to whom a loss resulting from the transfer would be disallowed under section 24 (b).

(4) Applicability.—This subsection shall apply with respect to any amount received, or payment made, pursuant to a transfer described in paragraph (1) in any taxable year beginning after May 31, 1950, regardless of the taxable year in which such transfer occurred."

Section 1235 of the Internal Revenue Code of 1954 is substantially identical with Section 117 (q) of the Internal Revenue Code of 1939.

Statement of the Matter Involved

In this action petitioners seek to recover alleged overpayments of income taxes for the years 1949, 1950, 1951 and 1952. The ultimate question is whether royalties received by petitioner[1] under the provisions of Exhibit A constituted ordinary income as claimed by the respondent and as held by the courts below or capital gain as claimed by petitioner. The respondent conceded that the patents in this case were long-term capital assets. For the years 1949 and 1950 the determining issue is whether Exhibit A effected a "sale" of patents within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939; for the years 1951 and 1952 the determining issue is whether Exhibit A transferred "property consisting of all substantial rights" to patents within the meaning of Section 117 (q) of the Internal Revenue Code of 1939.

The essential facts are stated briefly in the District Court's Finding of Facts.

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[1] Throughout this petition James R. Watkins is referred to as "the petitioner" since Lucile L. Watkins is party to this litigation solely by virtue of the fact that she is the wife of James R. Watkins and filed joint returns with him for the tax years in question.

"1. On April 17, 1934 there was issued to the plaintiff, James R. Watkins, U. S. Letters Patent No. 1,955,107 covering a wood cleated corrugated shipping container.

2. Subsequently, additional Letters Patent were issued to him for improvements on the shipping container as follows:

> October 9, 1934, Letters Patent No. 1,976,693; December 27, 1938, Letters Patent No. 2,141,497; and May 13, 1939, Letters Patent No. 2,159,642.

3. In March 1937 the plaintiff, James R. Watkins, entered the employ of Dillman Industries, Inc. of Caruthersville, Missouri, manufacturers of lumber, wooden boxes and crates, and at that time entered into an agreement with Dillman Industries, Inc. whereby Watkins granted to the corporation a non-exclusive license to manufacture containers under the patents which, up to that time, had been issued to him.

4. The manufacturing and sales of the shipping containers proved to be successful and early in 1940, after the last two patents relating to the shipping container had been issued to Watkins, negotiations went on between James R. Watkins and some of the officers and leading shareholders of Dillman Industries, Inc. acting both on behalf of the corporation and themselves personally, relative to new agreements for the exploitation of the patents.

5. During said period a new corporation, Watkins Patents, Inc., was organized under the laws of the State of Illinois in which the plaintiff, James R. Watkins, owned twenty per cent of the shares issued and outstanding and the remaining eighty per cent of said shares were owned by Dillman Industries, Inc. or officers and shareholders of Dillman Industries, Inc.

6. On April 17, 1940 the four patents above referred to were the subject of five agreements entered into, eodem instante, which may generally be summarized as follows (We have inserted the Exhibit letter at the beginning of each summary):

(a) Exhibit A.—An agreement between James R. Watkins and Watkins Patents, Inc. by which Watkins transferred to Watkins Patents, Inc. a non-transferable exclusive license for the use of and sublicensing under the patents. By the same agreement Watkins Patents, Inc. agreed to pay Watkins $3,600 in cash and twenty per cent of the stock in Watkins Patents, Inc. and one-third of the net royalties derived from licensed manufacture under the patents, subject to certain minor qualifications. Said contract provided further that Watkins had a non-transferable, non-exclusive sublicense under the patents, and that anyone with whom he became associated to practice his sublicense had a right to sublicense from Watkins Patents, Inc. even after the termination of the association between Watkins and such individual, copartnership or corporation. Said agreement further provided that in the event of litigation concerning said patents, or any of them, Watkins Patents, Inc. had a duty to defray the cost of such litigation up to the amount of $10,000 and that with regard to expenditures above said amount Watkins Patents, Inc. had the option of paying the additional amount necessary or to refuse to do so, in which event said James R. Watkins had the right to carry on such litigation at his own expense with certain provisions for reimbursement in the event of his successful prosecution or defense of said litigation. Said contract further provided that sublicenses of Watkins Patents, Inc. were sub-

ject to the approval of James R. Watkins and that all existing licenses were transferred to Watkins Patents, Inc. by James R. Watkins. The contract also provided that Watkins Patents, Inc. had a duty to account to Watkins and that copies of the contract and assignments of prior licenses should be in proper form for filing in the U. S. Patent Office.

(b) Exhibit B.—An agreement between Watkins Patents, Inc. and Dillman Industries, Inc. by which Dillman Industries received a non-transferable, non-exclusive license to manufacture and sell containers under the patents of Watkins Patents, Inc. in return for its payment to Watkins Patents, Inc. of royalties of one per cent of the net sales of containers sold under the license, such royalties to become one and one-half per cent in case the employment of James R. Watkins by Dillman Industries, Inc. was terminated.

(c) Exhibit C.—An agreement between Dillman Industries, Inc. and James R. Watkins by which a license previously granted to Dillman Industries, Inc. by Watkins was canceled. This agreement provided further that Watkins' employment contract with Dillman Industries, Inc. was terminated and a new employment contract entered into, under the terms of which Dillman Industries, Inc. was to pay Watkins $400 per month and twenty-five per cent of Dillman Industries' net income from the manufacture and sale of products under Watkins Patents. At the end of any year either party could terminate the employment contract by giving notice. The agreement also contained certain provisions concerning the holding by Watkins of stock in Dillman Industries, Inc.

(d) Exhibit D.—An agreement between James R. Watkins, Dillman Industries, Inc. and Watkins Patents, Inc. which incorporated agreement (a) above, canceled a previous license given by Watkins to Dillman Industries, Inc. and provided for the execution of a sublicense to Dillman Industries, Inc. from Watkins Patents, Inc. (agreement (b) above). The agreement contained certain other provisions, including Dillman Industries' promise to loan Watkins Patents, Inc. certain amounts for the purpose of paying litigation expenses that might arise in defense of Watkins' patents.

(e) Exhibit E.—An agreement between Watkins Patents, Inc. and James R. Watkins by which Watkins Patents, Inc. purported to grant James R. Watkins a non-transferable, non-exclusive license to manufacture and sell containers under the Watkins Patents in return for royalty payments of one and one-half per cent of the net sales of such containers. The agreement further provided that said license was not to be used by James R. Watkins as long as he was employed by Dillman Industries, Inc.; but that upon leaving the employment of Dillman Industries, Inc. (which at his option he might do at the end of any year), he might operate under the license, or if he became associated with any individual, co-partnership or corporation, such enterprise might manufacture and sell under his license. The agreement provided that upon termination of Watkins' association with any such individual, co-partnership or corporation, such individual, co-partnership or corporation would have the right to obtain a license from Watkins Patents, Inc. The agreement expressly provided that Watkins, upon

termination of such associations, might continue to use his license individually or enter into subsequent associations, one at a time, with other individuals, co-partnerships or corporations, which could use his license during the period of association and obtain a license from Watkins Patents, Inc. upon termination of the association."

The District Court held that the royalties received by the petitioner for all four years were ordinary income to him and not capital gain. The Court of Appeals affirmed.

Questions Presented

1. Is a transfer of patent rights prevented from being a "sale" of the patent rights within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights to a patent" within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, because the agreement of transfer contains provisions which (1) prohibit further transfer, (2) require approval of licensees by the transferor and (3) are conditions subsequent?

2. Does a non-transferable exclusive license for the use of and sublicensing under specified patents for the life of the patents constitute a "sale" of said patents within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights to a patent" within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, or does it constitute simply a "license to license" because the parties intended that the transferee use the patents by granting licenses thereunder to others to manufacture and sell the invention in return for royalty pay-

ments and not by itself manufacturing, selling or using the invention?

3. Does a transfer of the exclusive right to license others under specified patents, of the right to prosecute and defend infringement actions and of the rights of the transferor in outstanding licenses constitute a "sale" within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights" to the patents within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended?

Reasons for Granting the Writ

In holding that the transfer of patent rights is prevented from being a "sale" within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights to a patent" within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, because the agreement of transfer contains provisions which (1) prohibit further transfer, (2) require approval of licensees by the transferor and (3) are conditions subsequent, the Court of Appeals (a) decided an important question of federal law which has not been, but should be, settled by this Court, and (b) decided this question in a way which is in conflict with applicable decisions of this Court and with decisions of other Courts of Appeal.

The ultimate issue in this case is whether income to the petitioner for the transfer of patent rights is ordinary income or capital gain, a question which Judge Murrah began his majority opinion in *Dairy Queen of Oklahoma, Inc.* v. *Commissioner* (C. A. 10, 1957), 250 F. 2d 503, 504, by characterizing as "the familiar, yet still perplexing, question."

In the instant case the Court of Appeals held that the income was ordinary income because no sale or transfer of all substantial rights resulted due to the following rights "remaining in or bestowed upon" the petitioner: "(1) a right to royalties; (2) the power of termination in event of failure of the transferee to obtain necessary loans to conduct patent litigation; (3) Watkins' limited right to conduct patent litigation; (4) the restraint of non-transferability on the grant; (5) the fact that through the grant Watkins became a substantial shareholder in the transferee; (6) the reservation to Watkins of the license to manufacture and sell and to sublicense at reduced royalties and with a limited right of transferability; (7) Watkins' right to approve all sublicensees of the transferee."

The presence of these provisions in the agreements is conceded. The question is not one of construction of the agreements, but of legal effect of these provisions. Similar provisions are usual in agreements of this kind. They are designed to require "proper effort to promote the manufacture and sale of the patented article." *Allen* v. *Werner* (C. A. 5, 1951), 190 F. 2d 840, 842; *Carroll Pressure Roller Corp.* v. *Commissioner* (1957), 28 T. C. No. 152; app. dism'd on stip. (C. A. 9); *Commissioner* v. *Celanese Corp.* (C. A., D. of C., 1944), 140 F. 2d 339, 342; *Kronner* v. *United States* (Ct. Cls., 1953), 110 F. Supp. 730, 734; *United States* v. *Carruthers* (C. A. 9, 1955), 219 F. 2d 21, 25.

Under the Internal Revenue Code of 1939, this issue was decided by the courts, at least until 1956, on the basis of whether the transfer constituted an assignment or a license. That the document of transfer was termed an "exclusive license" did not prevent it from being an assignment. *Myers* v. *Commissioner* (1946), 6 T. C. 258, was typical of many decisions holding an "exclusive license" to be an assignment, notwithstanding installment payment of royalties and reservation of conditions subsequent. The Commis-

sioner of Internal Revenue first acquiesced in that decision (1946-1 C. B. 3), but in *Mimeo 6490*, 1950-1 C. B. 9, he withdrew that acquiescence and announced that for the taxable years beginning after June 1, 1950, he would regard royalties paid under such assignments or exclusive licenses as taxable as ordinary income, if payment were measured by the production, sale or use of the property transferred or if it were payable periodically over a period generally coterminous with the use of the patent. In the Internal Revenue Code of 1954, Congress included Section 1235 dealing with the sale or exchange of patents. The purpose of this section was stated to be "to obviate the uncertainty caused by this mimeograph and to provide an incentive to inventors to contribute to the welfare of the Nation * * * " Senate Report No. 1622, 83d Cong., 2nd Sess., pp. 438-441 (3 U. S. C. Cong. & Adm. News (1954) 5084, 5083). In 1956, in order to make the provisions of Section 1235 retroactive to taxable years beginning after May 31, 1950, Congress enacted Section 117 (q) as an amendment to the Internal Revenue Code of 1939. Senate Report No. 1941, 84th Cong. 2nd Sess., p. 5 (1956-2 Cum. Bull. 1227, 1229). Thus, the legislative history of Section 1235 is pertinent, particularly the explanation of the section contained in Senate Report No. 1622 at page 439:

> "The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. * * * It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been

> released to the transferee, rather than recognizing less relevant verbal touchstones. The word 'title' is not employed, because the retention of bare legal title in a transaction involving an exclusive license may not represent the retention of a substantial right in the patent property by the transferor. Furthermore, retention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as a security interest (e.g., a vendor's lien) or a reservation in the nature of a condition subsequent (e.g., a forfeiture on account of non-performance) are not to be considered as such a retention as will defeat the applicability of this section. On the other hand, a transfer terminable at will by the transferor would not qualify."

Congress has thus clearly stated the type of retained rights which "are not to be considered as such a retention as will defeat the applicability of this section." They must be "not of the nature of rights evidenced by the patent" and "not inconsistent with the passage of ownership." A "reservation in the nature of a condition subsequent" is not inconsistent with the passage of ownership.

This Court has consistently held that all that a patentee obtains by a patent is "the right to exclude everyone from making, using or vending the thing patented, without the permission of the patentee." *Bloomer* v. *McQuewan* (1852), 14 How. 539, 549. Only the very limited right of petitioner to conduct patent litigation after failure of Watkins Patents, Inc. to do so is of that nature. That right, however, is clearly not inconsistent with the passage of ownership since it is, like (2) and (6), in the nature of a condition subsequent. We therefore submit that the decision of the

Court of Appeals in the instant case is contrary to the Congressional intent in enacting Section 117 (q).

Many other courts have been called upon to consider the effect of rights similar to those present in this case. We do not find any other case in which the court has counted the number of so-called rights, as did the District Court and the Court of Appeals in this case, but all have examined the rights to determine their nature and effect. Almost without exception, the courts have held that the rights involved in the instant case are not inconsistent with the passage of ownership. A brief consideration of each of these rights may be helpful:

(1) Right to royalties—this provision does not reserve to petitioner "any control over the patent or its use" nor does it "limit or qualify the scope of the grant." *Watson* v. *United States* (C. A. 10, 1955), 222 F. 2d 689, 691. Contra *Bloch* v. *United States* (C. A. 2, 1952), 200 F. 2d 63; cert. den. 345 U. S. 935.

(2) Power to terminate—this provision is a condition subsequent. *Lawrence* v. *United States* (C. A. 5, 1957), 242 F. 2d 542, 545.

(3) Petitioner's right to conduct litigation if transferee failed to do so—this provision is analogous to a covenant to defend title. *Commissioner* v. *Celanese Corp.* (C. A., D. of C., 1944), *supra*, 342. It does not reserve "any property or proprietary right in the invention which was at variance with an assignment. * * * " *Watson* v. *United States* (C. A. 10, 1955), *supra*, 692.

(4) Restraint of non-transferability—this provision is intended to "protect the rights of the parties under the contract, not to proscribe, limit or qualify their intent and purpose * * * " *Watson* v. *United States* (C. A. 10, 1955), *supra*, 691.

(5) Petitioner became shareholder in transferee corporation—this is not the ownership of an interest in the patents. Cf. *Graham* v. *Commissioner* (1956), 26 T. C. 730; *Crook* v. *United States* (D. C., W. D. Penn., 1955), 135 F. Supp. 242, 252. Cf. also Section 117 (q)(3), Section 24 (b)(1)(B) of the Internal Revenue Code of 1939, and Senate Report No. 1622, p. 441, which deny capital gain treatment to sales to a corporation in which the seller owns fifty per cent of the stock. The ownership in this case is only twenty per cent.

(6) Sublicense to petitioner if he left employ of Dillman Industries, with limited right to transfer—this provision is a condition subsequent. *Watson* v. *United States* (C. A. 10, 1955), *supra*, 691.

(7) Approval of sublicenses—this provision "does not interfere with the full use of the patent by the assignee." *Rollman* v. *Commissioner* (C. A. 4, 1957), 244 F. 2d 634, 639. Cf. *Dreymann* v. *Commissioner* (1948), 11 T. C. 153, 161; Non-acq. 1950-2 C. B. 5.

Practically all of the decided cases on this point have a grouping of these rights. In the vast majority of the decisions it has been held that a sale resulted, notwithstanding the retention of these rights. We submit that the decisions in the following cases constitute the prevailing view in the courts, both before and after the application of Section 117 (q), and that the decision in the instant case is in conflict with the decisions in these cases:

Watson v. *United States* (C. A. 10, 1955), *supra*;
Dairy Queen of Oklahoma, Inc. v. *Commissioner* (C. A. 10, 1957), *supra*;
Rollman v. *Commissioner* (C. A. 4, 1957), *supra*;
Lawrence v. *United States* (C. A. 5, 1957), *supra*;
Kavanagh v. *Evans* (C. A. 6, 1951), 188 F. 2d 234;

Commissioner v. *Celanese Corp.* (C. A., D. of C., 1944), *supra;*

Kronner v. *United States* (Ct. Cls., 1953), *supra;*

Golconda Corp. v. *Commissioner* (1957), 29 T. C. No. 57;

Carroll Pressure Roller Corp. v. *Commissioner* (1957), *supra;*

Crook v. *United States* (D. C. W. D. Penn., 1955), *supra;*

First National Bank of Princeton v. *United States* (D. C. N. J., 1955), 136 F. Supp. 818; app. dism'd (C. A. 3).

The decision in the instant case extends the holding of the same court in *Bloch* v. *United States* (C. A. 2, 1952), *supra*, to Section 117 cases. In the *Bloch* case the Court of Appeals, at page 66, admitted that its decision was contrary to those in *Allen* v. *Werner* (C. A. 5, 1951), *supra, Commissioner* v. *Celanese Corp.* (C. A., D. of C., 1944), *supra* and decisions of the Tax Court in *Kimble Glass Co.* v. *Commissioner* (1947), 9 T. C. 183 and the *Myers* case.

Until the questions at issue in these cases and in the instant case are settled by this Court great uncertainty will exist and inventors cannot have the incentive to contribute to the welfare of the Nation which Congress sought to give them by the enactment of Section 1235 of the Internal Revenue Code of 1954 and of Section 117 (q) of the Internal Revenue Code of 1939, as amended in 1956. Different results by the various courts ruling on substantially identical contract provisions are clearly not conducive to such encouragement.

II

In affirming the District Court's decision that a non-transferable exclusive license for the use of and sublicensing under specified patents for the life of the patents did not constitute a "sale" of said patents within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights to a patent" within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, but rather did constitute simply a "license to license" because of the fact that the parties intended that the transferee use the patents by issuing licenses thereunder to others to manufacture and sell the invention and not by itself manufacturing, selling or using the invention, the Court of Appeals decided an important question of federal law which has not been, but should be, settled by this Court.

The District Court said that "under certain circumstances and in certain contexts" the language used in the granting clause of Exhibit A could be construed to convey all substantial rights to a patent. That language is, "does hereby transfer and grant * * * the non-transferable exclusive license for the use of and sublicensing under each and all * * * the patents." Decisions construing the words "use of the patent" or similar wording to constitute a sale of patent rights are: *Reid* v. *Commissioner* (1956), 26 T. C. 622; Acq. 1956-2 C. B. 8; *Associated Patentees, Inc.* v. *Commissioner* (1945), 4 T. C. 979; Acq. 1946-1 C. B. 1; *United States* v. *Borton* (D. C., N. J., 1950), 1950 1 U. S. T. C. 9276; *Pike* v. *United States* (D. C., Conn., 1951), 101 F. Supp. 100; *Daily* v. *Universal Oil Products Co.* (D. C., Ill., 1947), 76 F. Supp. 349, 356; *Graber* v. *United States* (D. C., Ore., 1958), 158 F. Supp. 510. This Court has frequently employed the term "use of the patent" as meaning "make, use and sell under the patent." For instance, in *Continental Paper Bag Co.* v.

Eastern Paper Bag Co. (1908), 210 U. S. 405, at page 425, this Court said:

> " * * * It shows that whenever this court has had occasion to speak it has decided that an inventor receives from a patent the right to exclude others from its use for the time prescribed in the statute * * *
>
> "And, in *Bloomer* v. *McQuewan*, 14 How. 539, 549, Chief Justice Taney said: 'The franchise which the patent grants consists altogether in the right to exclude everyone from making, using or vending the thing patented, without the permission of the patentee. This is all that he obtains by the patent.' "

It seems clear that "the right to exclude others from its use" in the first sentence is synonymous with "the right to exclude everyone from making, using or vending the thing patented" in the second.

It is a fact also that Section 117 (q)(1)(A) employs the term "transferee's use of the patent" as synonymous with "purchaser's use of the patent."

Other provisions of Exhibit A are clearly indicative of an intention to effect an assignment and not a license. The provision granting the transferee the right to conduct infringement litigation is one, since a licensee has no right to sue infringers. *E. W. Bliss Co.* v. *United States* (1920), 253 U. S. 187, 192; *Littlefield* v. *Perry* (1874), 21 Wall. 205, 223. In *Pike* v. *United States, supra* the Court regarded this right as very significant.

The provision of Exhibit A expressly transferring all existing licenses to the transferee is a further indication of an intent to pass full ownership to the transferee. *Hook* v. *Hook & Ackerman, Inc.* (C. A. 3, 1951), 187 F. 2d 52, 58. The provisions of Exhibit A that copies of the contract and assignments of prior licenses should be in proper form for

filing in the U. S. Patent Office is also an indication, since these are common provisions in assignments. *Ellis, Patent Assignments* (3rd ed.), Sections 334, 336.

The surrender by Dillman Industries, Inc. of the license issued to it by petitioner and the issuance of a new license (Exhibit B) from Watkins Patents, Inc. to it is still further indication of where the parties intended ownership to rest, as is the issuance by Watkins Patents, Inc. to petitioner of a license (Exhibit E). The issuance of these two licenses by Watkins Patents, Inc. is a practical construction of Exhibit A by the parties and is conclusive evidence that the parties contemplated that all proprietary rights would be transferred to Watkins Patents, Inc. by Exhibit A. Exhibit E is also clear evidence that petitioner intended to give up all right to manufacture and sell since he felt that he needed a license from Watkins Patents, Inc. to do so if he should ever leave Dillman Industries. Cf. *Cutter Laboratories* v. *Lyophile-Cryochem Corp.* (C. A. 9, 1949), 179 F. 2d 80, 93. If Exhibit A transferred only the power to license, Exhibit E was entirely unnecessary and Exhibit B should have run from petitioner to Dillman Industries, Inc. as did the prior license. In fact, if Exhibit A was not an assignment but only a license, Watkins Patents, Inc. received no right to issue licenses in its own name but should have issued those licenses in petitioner's name, which was not done.

The District Court held, however, that Exhibit A could not constitute an assignment or transfer of all substantial rights to a patent because the parties did not intend Watkins Patents, Inc. to manufacture and sell under the patents but to issue licenses to others. The decision was based on *Six-Wheel Corporation* v. *Sterling Motor Truck Co.* (C. A. 9, 1931), 50 F. 2d 568. In the opinion of Judge Wyzanski, stated in *Standard Oil Co.* v. *Markham* (D. C., S. D. N. Y. 1945), 64 F. Supp. 656, 662; aff'd and mod. (C. A. 2) 163 F.

2d 917; cert. den. 333 U. S. 873; that decision "is so plainly at variance with the weight of authority that it should be discredited * * * "

We respectfully submit that the effect of the decision in the instant case is that a patent holding company cannot be organized to be the owner of a patent. In view of the thousands of such companies which now exist, this decision is of far-reaching importance. The Hartford-Empire Company was an outstanding example—it was purely a patent holding company engaged in licensing others. *Hartford-Empire Co.* v. *United States* (1945), 323 U. S. 386. In *Associated Patentees, Inc.* v. *Commissioner* (T. C. 1950), *supra,* and *United States* v. *Borton* (D. C. N. J., 1950), *supra,* both the Tax Court and the District Court held that Associate Patentees, Inc. was the owner of patents by assignment although it engaged solely in the business of licensing others. Similarly, in *Massey* v. *United States* (C. A. 7, 1955), 226 F. 2d 724, the finding discloses that the assignee was not a manufacturer.

In *Hartford-Empire Co.* v. *United States, supra,* this Court said, at page 432, that a patent owner "has no obligation either to use it or to grant its use to others" and, at page 417, that patent owners have always enjoyed the option either to "set the price for its use by others, elect to use it himself and refuse to license it, or to retain it and neither use nor license it." By the express words of Exhibit A the transferee in the instant case received the exclusive license to use the patent and to sublicense thereunder. The decision on this point, that because Watkins Patents, Inc. did not use the patents but did license them, it could not be the owner of the patents, is contrary to the position taken by this Court.

III

In affirming the District Court's decision that a transfer of the exclusive right to license others under specified patents, of the right to prosecute and defend infringement actions, and of the rights of the transferor in outstanding licenses does not constitute a "sale" of those patents within the meaning of Section 117 (a)(4) of the Internal Revenue Code of 1939 or a "transfer of property consisting of all substantial rights" to the patents within the meaning of Section 117 (q) of the Internal Revenue Code of 1939, as amended, the Court of Appeals decided an important question of federal law which has not been, but should be, settled by this Court.

Section 154 of Title 35 of the United States Code governs the rights contained in the grant of a patent:

> "Every patent shall contain a short title of the invention and a grant to the patentee, his heirs or assigns, for the term of seventeen years, of the right to exclude others from making, using or selling the invention throughout the United States, referring to the specification for the particulars thereof. A copy of the specification and drawings shall be annexed to the patent and be a part thereof."

The "right to exclude others" is given to "the patentee, his heirs or assigns"; it seems clear that only the "owner" can have this right. See *Bauer* v. *O'Donnell* (1913), 229 U. S. 1, 10; *Ethyl Gasoline Corp.* v. *United States* (1940), 309 U. S. 436, 456. This right to exclude others is "the essence of the patent privilege." *Transwrap Corp.* v. *Stokes Co.* (1947), 329 U. S. 637, 643. It is also the essence of property ownership. *Rohmer* v. *Commissioner* (C. A. 2, 1946), 153 F. 2d 61, 63, note 9; cert. den. 328 U. S. 862. In the identical type of case the Court said, in *Dairy Queen of*

Oklahoma, Inc. v. *Commissioner* (C. A. 10, 1957), *supra*, at page 506:

> "Of course if the conditions and restrictions upon the exercise of the granted right were such as to reserve in the grantor the proprietary right in the franchise, the grant would be something less than a sale and probably a mere license. But the traditional test of ownership is the power to exclude others. Taxation is not concerned with refinements of title, but with actual command of the property. See *Corliss* v. *Bowers*, 281 U. S. 376, 50 S. Ct. 336, 74 L. Ed. 916; *Griffiths* v. *Helvering, Commissioner*, 308 U. S. 355, 60 S. Ct. 277, 84 L. Ed. 319."

The right to sue for patent infringement "is considered as the primary indicia of true ownership of a patent." *Young* v. *Commissioner* (1958), 29 T. C. No. 92. Since he does not possess the right to exclude others, it follows that a licensee cannot license others to use the patent. In *Ellis, Patent Assignments*, Sec. 55, the author states:

> " * * * The broad fundamental practical difference between an assignment and a license is that the former gives the transferee the right to sue for infringement and the latter gives the transferee immunity from suit for infringement. The first gives positive rights, the second negative rights."

The decision in the instant case is contrary (1) to the express wording of the statute in that it holds that a transfer of the right to exclude others does not constitute an assignment but only a license, although the statute gives that right only to the patentee, his heirs or assigns, and (2) to the many decisions which give effect to the ownership denoted by the right to exclude others. Certainly, if the

right to exclude others is the essence of the patent privilege, the patentee's complete transfer of that right should be held to be a transfer of all substantial rights to the patent.

Here again the decision of the Court of Appeals is contrary to the legislative intent. *Senate Report No. 1622*, page 439, *supra* states:

> " * * * The section does not apply to a property right in an invention differing from the monopoly rights evidenced by a patent. * * * "

The report also states the sole requirement "that all substantial rights evidenced by the patent" must be transferred. The substantial rights evidenced by the patents and the monopoly rights evidenced by the patents, being simply the right to exclude others from use of the patents, were transferred in the instant case. The legislative intent requires that this transfer be held to be a "transfer of property consisting of all substantial rights" to these patents.

CONCLUSION

It is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted.

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APPENDIX A

Opinion of Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 108—October Term, 1957.

(Argued November 15, 1957 Decided February 26, 1958.)

Docket No. 24663

JAMES R. WATKINS and LUCILE L. WATKINS,

Appellants,

—v.—

UNITED STATES OF AMERICA,

Appellee.

Before:

CLARK, *Chief Judge,*

MOORE, *Circuit Judge* and LEIBELL, *District Judge.*

Appeal from United States District Court for the District of Connecticut; Robert P. Anderson, *Judge.*

James R. Watkins and Lucile L. Watkins appeal from the dismissal on the merits, 149 F. Supp. 718, of their action against the United States of America for refund of income taxes paid by them for the years 1949 through 1952 on royalty payments received under a patent licensing agreement.

Affirmed.

JOHN H. WEIR, Esq., New Haven, Conn. (Curtiss K. Thompson, Esq., New Haven, Conn., on the brief), *for plaintiffs-appellants, James R. Watkins and Lucile L. Watkins.*

JOHN N. STULL, Esq., Department of Justice, Washington, D. C. (Charles K. Rice, Assistant Attorney General, Lee A. Jackson, Harry Baum, Grant W. Wiprud, Attorneys, Department of Justice, Washington, D. C., Simon S. Cohen, United States Attorney for the District of Connecticut, on the brief), *for appellee, United States of America.*

MOORE, *Circuit Judge*:

The primary question on this appeal is whether royalty payments received by an inventor, James R. Watkins, and his wife (the taxpayers), during the years 1949 through 1952 from an assignment of the patents should have been treated as capital gains derived from a sale of assets held more than six months (*i.e.* payments on account of the purchase price of the patents) or were merely ordinary income received under a licensing agreement. The district court held that the payments were properly taxed at income tax rates and denied the plaintiffs' claim for a refund.

The applicable sections of the Internal Revenue Code of 1939 are section 117(a)(4), which governs the royalty payments received in the years 1949 and 1950, and section 117(q) (as added by amendment June 29, 1956, 70 Stat. 404), which governs those payments received in the years 1951 and 1952. Section 117(a)(4) defines "long-term capital gain" as the "gain from the exchange or sale of a capital asset held for more than 6 months." Section 117(q) relates specifically to the transfer of patent rights and states that

as a "*General Rule.*—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are— (A) payable periodically over a period generally coterminous with the transferee's use of the patent, or (B) contingent on the productivity, use, or disposition of the property transferred."

As the Senate noted in its report on section 1235 of the Internal Revenue Code of 1954, which is substantially the same as section 117(q) of the 1939 Code, the test in determining for income tax purposes whether a patent has been sold is a realistic one. "[T]he entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones." Sen. Rep. No. 1622, 83d Cong., 2d Sess., pp. 439-40. Accordingly, to answer the question whether the transfer of the patents from Watkins to Watkins Patents, Inc. was an assignment or a license, it is necessary to examine in some detail the transaction alleged to have been an assignment as well as other facts relating thereto.

In 1937 the taxpayer, Watkins, became an employee of Dillman Industries, Inc., which was engaged in the manufacturing and marketing of wooden boxes and crates. At that time Watkins was the holder of two patents covering wood cleated corrugated shipping containers and had granted to Dillman Industries, Inc. a non-exclusive license to manufacture and sell containers covered by the patents. In addition to Dillman Industries, Inc. licenses had also been granted by Watkins to five other Midwestern firms.

During 1938 and 1939 Watkins obtained two additional patents for improvements on the invention.

The manufacture and sale of the containers proved to be successful and in 1940 Watkins and the management of Dillman Industries, Inc., desirous of obtaining wider acceptance of patented products, determined that the best way of obtaining such acceptance was through extensive licensing to other firms in the industry. To this end they organized in 1940 a new corporation, Watkins Patents, Inc., the function of which was to grant limited territorial licenses to manufacture and sell the patented products.

To carry out the plan, five agreements, dated April 27, 1940, were entered into simultaneously, consisting of: (1) an agreement between Watkins and Watkins Patents, Inc. (Exh. A); (2) an agreement between Watkins Patents, Inc. and Dillman Industries, Inc. (Exh. B); (3) an agreement between Watkins and Dillman Industries, Inc. (Exh. C); (4) an agreement between Watkins, Dillman Industries, Inc. and Watkins Patents, Inc. (Exh. D); and (5) an agreement between Watkins and Watkins Patents, Inc. (Exh. E).

By the agreement (Exh. A) Watkins transferred and granted to Watkins Patents, Inc. "the non-transferable exclusive license for the use of and sublicensing under each and all of the above referred to patents, * * * together with all licensing agreements heretofore made under said patents by first party [Watkins] as hereinabove specifically set forth." In return therefor Watkins received $3,800 in cash, one-fifth of the stock of Watkins Patents, Inc. (the other 80% being held by Dillman Industries, Inc. or members of its management) and one-third of the net royalties Watkins Patents, Inc. received from the patented products sold, or an amount equal to 1% of the net sales price of all patented products sold, whichever was greater. In addition to the cash, stock and royalty payments (the tax treatment of which is in issue here), Watkins Patents, Inc.

further agreed to give Watkins a non-transferable, non-exclusive license to manufacture and sell at a reduced royalty rate of 1½% of the net sales price. Watkins, however, could not use this license so long as he remained an employee of Dillman Industries, Inc. Although the license was described as non-transferable, any company, not a licensee of Watkins Patents, Inc., with which Watkins should become connected, could operate under the license and in the event that he severed his connection with such company it would still retain the right to operate under the license at the reduced royalty rate. Watkins could also continue to bestow upon any other company with which he might become associated in the future the same licensing rights. In addition Watkins retained the right to approve all sub-licensees of Watkins Patents, Inc. Not only did this veto right give him considerable power over the operations of the corporation but it tended to defeat the purported exclusiveness of the corporation's power to sublicense.

Under the agreement between Watkins Patents, Inc. and Dillman Industries, Inc. (Exh. B) a non-transferable, non-exclusive license was given by Watkins Patents, Inc. to Dillman Industries, Inc. to manufacture and sell the patented products at a reduced royalty of 1% of net sales, to be increased to 1½% if Watkins left the employ of Dillman Industries, Inc. The agreement between Watkins and Dillman Industries, Inc. (Exh. C) provide for the cancellation of the original license from Watkins and for Watkins' employment under a new employment contract with Dillman Industries, Inc. The three-party agreement (Exh. D) between Watkins, Watkins Patents, Inc. and Dillman Industries, Inc. provided for the acceptance by Dillman Industries, Inc. of the provisions of the grant from Watkins to Watkins Patents, Inc. contained in the agreement (Exh. A) and the fifth agreement (Exh. E) gave back to Watkins a sublicense from Watkins Patents, Inc. as defined in the first agreement between them (Exh. A).

Appellants argue that the grant of a "license for the use of and sublicensing under each and all of the above referred to patents" conveyed to Watkins Patents, Inc. the right to manufacture and sell the patented products. They, therefore, conclude that appellants thereby divested themselves, in effect, of their interests in the patents. It is unnecessary, however, to pass upon that issue because, even assuming that Watkins Patents, Inc. received these rights, as a result of the five agreements which must be considered together, Watkins emerged from the transaction possessed of so many rights and interests both present and future that much less than a complete transfer was achieved by the transaction.

Among the rights remaining in or bestowed upon Watkins by the various agreements were: (1) a right to royalties; (2) the power of termination in event of failure of the transferee to obtain necessary loans to conduct patent litigation; (3) Watkins' limited right to conduct patent litigation; (4) the restraint of non-transferability on the grant; (5) the fact that through the grant Watkins became a substantial shareholder in the transferee; (6) the reservation to Watkins of the license to manufacture and sell and to sublicense at reduced royalties and with a limited right of transferability; (7) Watkins' right to approve all sublicensees of the transferee.

The district court recognized that it would have been possible for Watkins to have retained some legal interests in the patents without reducing the purported assignment or sale to a license (see the citation of various situations discussed by the courts and set forth in the trial court's opinion, 149 F. Supp. 718, 724). Appellants argue that each of these retained interests was merely incidental to, and not in itself inconsistent with, the passage of ownership, and that the entire aggregate of such interests did not add up to the reservation of substantial rights.

Summarizing the more important features of the retained rights, Watkins Patents, Inc. could not transfer its power to sublicense; Watkins at any time after one year could transfer a valuable and irrevocable sublicense to any firm which he desired to join; Watkins had a veto power over the sublicensees of Watkins Patents, Inc.; and Watkins possessed the conditional right to take over and control patent litigation. By virtue of his stock interest in Watkins Patents, Inc. and his veto power, Watkins also could have had a considerable voice in the affairs of that company.

As the district court clearly pointed out, in no case where an assignment was found did such a mass of interests remain in the transferor. It may well be that Watkins desired to divest himself of many of his rights for tax purposes but at the same time retain as many as possible. In so doing, however, he must accept the risk that the transfer might not meet the standard of releasing "substantially all rights of the owner in the patented property." The very multiplicity of agreements simultaneously executed is significant. Had Watkins desired to divest himself irrevocably of substantially all rights in his patents such a transfer could have been accomplished in a single agreement in simple language conveying such rights.

The conclusion of the trial court "that the plaintiffs have failed to establish that James R. Watkins and those contracting with him either intended or accomplished a sale or assignment of the patents to Watkins Patents, Inc. and the payments in question must be treated as ordinary income and not as capital gains" is clearly justified by an accurate analysis of the agreements evidencing the transaction.

The judgment is affirmed.

APPENDIX B

Judgment

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court house in the City of New York, on the 26th day of February one thousand nine hundred and fifty-eight.

Present:

HON. CHARLES E. CLARK,
Chief Judge.

HON. LEONARD P. MOORE,
Circuit Judge.

HON. VINCENT L. LEIBELL,
District Judge.

JAMES R. WATKINS and LUCILE L. WATKINS,
Plaintiffs-Appellants,

—v.—

UNITED STATES OF AMERICA,
Defendant-Appellee.

Appeal from the United States District Court for the District of Connecticut.

This cause came on to be heard on the transcript of record from the United States District Court for the District of Connecticut, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk